

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 21st Floor
San Francisco, California 94105**

INITIAL STATEMENT OF REASONS

Date: August 7, 2002

RH02019392

**REGULATIONS CONCERNING VALUATION OF LIFE
INSURANCE POLICIES, INCLUDING INTRODUCTION AND
USE OF NEW SELECT MORTALITY FACTORS, PURSUANT TO
INSURANCE CODE SECTION 10489.94**

INTRODUCTION

Pursuant to Insurance Code section 10489.94 (the "Statute"), Insurance Commissioner Harry Low proposes to add to California Code of Regulations, Title 10, Chapter 5, Subchapter 3 the new Article 12.3, entitled "Valuation of Life Insurance Policies." The provisions of the proposed regulations, as embodied in Department of Insurance Bulletin Number 2000-2 (the "Bulletin"), have been in force since that bulletin was issued on July 1, 2000 pursuant to the Statute. The Statute requires that the Commissioner adopt regulations to supersede the Bulletin by December 31, 2002. The Statute also specifies that it is the intent of the Legislature that the Bulletin and the proposed regulations shall contain the provisions of the National Association of Insurance Commissioners ("NAIC") Valuation of Life Insurance Model Regulation Number 830 as adopted in March of 1999 (the "Model Regulation").

The Commissioner believes that the proposed regulations are necessary to carry out the express intent of the Legislature, as articulated in the Statute, that the provisions of the Model Regulation be adopted. Indeed, for the most part, the text of the proposed regulations copies the language of the Model Regulation *verbatim*, with only nonsubstantive changes in grammar, format and numbering. In instances where substantive language has been added, in each case identified and discussed separately below, the change was necessary in order to comply or avoid conflict with California law, to resolve ambiguities present in the Model Regulation or to make explicit the underlying principle of the Model Regulation: Reserves need to be established that are commensurate with the guarantees made in a policy; plans which in effect mask those guarantees or seek to take advantage of a perceived loophole should be subject to the same reserving requirements as more conventional plans with comparable guarantees.

To the extent that the proposed regulations contain the provisions of the Model Regulation they are reasonably necessary not only in order to carry out the intent of the Legislature but also in order facilitate an efficient and consistent regulatory framework governing valuation of life

insurance policies on a nationwide basis. Many insurers write life policies in multiple states. Thirty-seven other states have adopted some form of the Model Regulation. It can be beneficial to both insurers and consumers when administrative costs related to compliance with multiple, inconsistent regulatory requirements imposed by different states are reduced. The proposed regulations tend to serve this purpose by ensuring that California's regulatory requirements in this area are as consistent with those of other states as is possible under California law. To the extent that insurers, operating in compliance with California law, are able to devote additional resources — resources which would otherwise be expended satisfying multiple, inconsistent regulatory regimes — to improving their financial stability or providing better products to consumers, everyone stands to benefit. The proposed regulations are reasonably necessary to the degree to which they help to achieve progress toward this goal.

SPECIFIC PURPOSE AND REASONABLE NECESSITY OF REGULATION

The specific purpose of each adoption and the rationale for the Commissioner's determination that each adoption is reasonably necessary to carry out the purpose for which it is proposed are set forth below.

SECTION 2542. PREAMBLE

This section specifies the Statute as the California authority under which the proposed regulations are promulgated. It also indicates that they are to supersede Department of Insurance Bulletin Number 2000-2. The provision of this information is reasonably necessary for purposes of clarity and ease of reference. In all other respects, the language is substantially identical to that of the Model Regulation; this section is therefore reasonably necessary in order to carry out the intent of the Legislature that the proposed regulations contain the provisions of the Model Regulation.

SECTION 2542.1. PURPOSE

This section specifies the purpose of the proposed regulations. It is substantially identical to the corresponding section of the Model Regulation; Section 2542.1 is therefore reasonably necessary in order to carry out the intent of the Legislature that the proposed regulations contain the provisions of the Model Regulation.

SECTION 2542.2. APPLICABILITY

This section specifies the scope of the proposed regulations in terms of the range of life insurance policies to which they apply. It also sets out the requirement that the minimum valuation standards for policies (other than universal life policies) with guaranteed nonlevel benefits or gross premiums, and for flexible premium and fixed premium universal life policies with secondary guarantees, be as set forth in Sections 2542.5 and 2542.6, respectively. Section 2542.2 is substantially identical to the corresponding section of the Model Regulation; this section is therefore reasonably necessary in order to carry out the intent of the Legislature that the proposed regulations contain the provisions of the Model Regulation.

SECTION 2542.3. DEFINITIONS

This section defines technical terms used throughout the proposed regulations. With the exceptions of Subdivision (b), Subdivision (f) and Subdivision (j) as discussed below, Section 2542.3 is in all respects substantially identical to the corresponding section of the Model Regulation; this section is therefore reasonably necessary in order to carry out the intent of the Legislature that the proposed regulations contain the provisions of the Model Regulation.

Section 2542.3, Subdivision (b)

In order to avoid conflict with Insurance Code section 10489.2, it has been necessary to include in the text of the proposed regulations the following addition to the corresponding language in the Model Regulation: “All calculations are made using the 1980 CSO Valuation Tables, as defined in [Subdivision (f)] of this Section [2542.3], (or any other valuation mortality table adopted by the National Association of Insurance Commissioners (NAIC)) after the effective date of this [article] and **approved by regulation** promulgated ~~by regulation~~ **or bulletin issued** by the commissioner for this purpose), and, if elected, the optional minimum mortality standard for deficiency reserves stipulated in Section [2542.4(b)] of [this article].”

Insurance Code Section 10489.2 identifies as one of the bases of the minimum standard for the valuation of policies to which the Standard Valuation Law¹ is applicable the mortality tables identified in Subdivision (a) of that section. For the mortality tables to be used with all “ordinary” (as opposed to industrial) policies including those issued on or after the effective date of the proposed regulations, and to which the proposed regulations therefore apply, Subdivision (a) specifies three options, as follows:

(i) the Commissioners 1980 Standard Ordinary Mortality Table, or (ii) at the election of the company for any one or more specified plans of life insurance, the Commissioners 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors, or (iii) any ordinary mortality table, adopted after 1980 by the National Association of Insurance Commissioners, or its successor, that is approved by regulation promulgated or bulletin issued by the commissioner for use in determining the minimum standard of valuation for such policies. Ins. Code § 10489.2, subd. (a).

Because Insurance Code Section 10489.2 thus allocates to the Commissioner the authority to approve “other” applicable mortality tables by bulletin, as well as by regulation, the proposed regulations would be at odds with the Insurance Code if they were to circumscribe the range of statutorily provided alternatives to only those tables approved by regulation. The above-identified language which in the proposed regulations has been inserted into the text of the Model Regulation therefore represents an additional provision that is reasonably necessary in order to avoid creating an inconsistency with California statutory law.

¹ Insurance Code, Division 2, Part 2, Chapter 5, Article 3A, into which the Statute has been inserted.

Section 2542.3, Subdivision (f)

In order to avoid conflict with Insurance Code sections 790.03 and 10489.2, as well as to comply with Government Code sections 11340.5 and 11349.1, and with Title 1, California Code of Regulations, sections 16 and 20, it has been necessary to make the following additions to the corresponding language in the Model Regulation:

"1980 CSO Valuation Tables" means the Commissioners' 1980 Standard Ordinary Mortality Table (1980 CSO Table) **(1981 *Transactions of the Society of Actuaries*, Volume 33, pp. 618, 673)**, without select factors, incorporated into the 1980 amendments to the NAIC Standard Valuation Law, and variations of the 1980 CSO Table approved by the NAIC **and approved by regulation promulgated or bulletin issued by the commissioner**, ~~such as the smoker and nonsmoker versions approved in December 1983.~~ **"1980 CSO Valuation Tables" includes the 1980 CSO Female Smoker and Non-smoker Mortality Rates, and the 1980 CSO Male Smoker and Non-smoker Mortality Rates, tables approved by the NAIC in December 1983 (1984 *Proceedings of the National Association of Insurance Commissioners*, I, pp. 406-407, 410-411), which tables are approved by the commissioner for purposes of this article. For valuation under this article of life insurance contracts issued pursuant to arrangements which may be considered terms, conditions, or privileges of employment within the meaning of Subdivision (f) of Insurance Code Section 790.03, "1980 CSO Valuation Tables" also includes the Blended 1980 CSO Tables B through F, approved by the NAIC in December 1983 (1984 *Proceedings of the National Association of Insurance Commissioners*, I, pp. 396-400), which tables are approved by the commissioner for purposes of this article only for use with such contracts. The 1980 CSO Valuation Tables are hereby incorporated herein by reference.**

State agencies are required to adopt as a regulation any "standard of general application, or other rule" they seek to enforce. Gov. Code § 11340.5. Since each of the tables indicated in the Model Regulation's definition of "1980 CSO Valuation Tables" could be construed to qualify as such a standard or rule, each must, arguably, be adopted as part of the proposed regulations, pursuant to the Administrative Procedure Act. In order to make the tables part of the present regulations, it is necessary either to reprint the tables in the text of the proposed regulations or to incorporate the tables by reference into the proposed regulations.

Reprinting the tables in the California Code of Regulations would be impractical, because it would unnecessarily introduce the possibility of error and because, owing to the fact that the tables in question have been in use for over fifteen years among insurers who are to be affected by the proposed regulations, reprinting the tables in the California Code of Regulations would not be particularly useful. For this reason, it has been reasonably necessary to incorporate by reference the 1980 CSO Valuation Tables, as defined in the Model Regulation, into the proposed regulations.

Title 1, California Code of Regulations, section 16 indicates that in the text of proposed regulations citation styles should be used that “clearly identify published material cited.” Cal. Code Regs., tit. 1, § 16. Title 1, California Code of Regulations, section 20 requires that for documents to be incorporated by reference the regulation text include an identification of such documents by “title and date of publication,” a specification of “which portions of the document[s] are being incorporated by reference,” and the inclusion of a statement to the effect that the documents are being incorporated by reference. Cal. Code Regs., tit. 1, § 20. For this reason it has been reasonably necessary in the regulation text to include such a statement and to provide the required bibliographical information for each set of tables.

The Model Regulation defines “1980 CSO Valuation Tables” to include the Commissioner’s Standard Ordinary Mortality Table (the 1980 CSO Table). This reference is to the same tables as are specifically indicated by Insurance Code section 10489.2 to be among those that may be used as a basis of the minimum standard of valuation of life policies subject to the proposed regulations. However, the Model Regulation also includes in the definition of “1980 CSO Valuation Tables” the following language: “variations of the 1980 CSO Table approved by the NAIC, such as the smoker and nonsmoker versions approved in December 1983.” In order to avoid conflict with Insurance Code section 10489.2 and to ensure compliance with Government Code section 11340.5, substantial additional language must be added in the text of the proposed regulations so that this provision of the Model Regulation can be effectuated to the fullest extent legally possible, as explained below.

As has been pointed out, Insurance Code section 10489.2 specifies which tables may be used as a basis of the minimum standard for valuation of policies to which the Standard Valuation Law, and therefore the proposed regulations, apply. These include, in addition to the Commissioner’s 1980 Standard Ordinary Mortality Table and the Commissioner’s 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors, tables adopted by the NAIC that are “approved by regulation promulgated or bulletin issued by the commissioner for use in determining the minimum standard of valuation for such policies.” Ins. Code § 10489.2, subd. (a). As this language indicates, approval by the NAIC, without more, is not sufficient. In order for a table to be used as a basis for valuation of life policies, it must also be approved by bulletin issued or regulation promulgated by the commissioner. Language to the effect that the additional tables indicated in the Model Regulation are approved by the commissioner for certain purposes under the proposed regulations has therefore been added to the definition of 1980 CSO Valuation Tables in the regulation text.

As it happens, only two “variations” of the 1980 CSO Table have subsequently been approved by the NAIC. One such variation consists of the “smoker and nonsmoker versions approved in December 1983” indicated in the language of the Model Regulation. As discussed above, language identifying these tables by title and providing the requisite bibliographic citations has been added in order to comply with the Government Code. In order to satisfy the requirement of Insurance Code section 10489.2 that tables to be used as a basis for valuation also be approved by the commissioner, language to the effect that the 1980 Male, and the 1980 Female, Smoker and Non-smoker Mortality Rates tables are approved for purposes of the proposed regulations

has been inserted. The only other mortality tables in existence that fall within the Model Regulation's definition of CSO Valuation Tables are the Blended 1980 CSO Tables B through F, otherwise known as the "Unisex Tables." Similar language has been inserted into the proposed regulations in order to satisfy the same Government Code and Insurance Code requirements with respect to the Unisex Tables. However, in order to avoid potential conflict with Insurance Code section 790.03, the Unisex Tables' inclusion within the definition of "1980 CSO Valuation Tables" in the proposed regulations requires additional language which articulates special limitations on the use of these tables.

Insurance Code section 790.03 prohibits "unfair discrimination between individuals of the same class and equal expectation of life in the rates charged for any contract of life insurance ... or in the benefits payable thereon." Ins. Code § 790.03, subd. (f). The statute further provides that this provision is to be interpreted "to *require* differentials based upon the sex of the individual insured ... in the rates ... or benefits, or any combination thereof." Ins. Code § 790.03, subd. (f) (emphasis added). Though the proposed regulations do not directly govern the rates or benefits connected to life insurance policies, rates and benefits are nonetheless among the main factors considered in the valuation calculations used in determining legally required reserves. Because it is possible that the proposed regulations could thus have an indirect influence on rates or benefits, they could be construed to be inconsistent with the spirit, if not the letter, of the law as articulated in Insurance Code section 790.03 to the extent they authorize the use of mortality tables which, as is the case with the Unisex Tables, do not differentiate based upon the sex of the insured.

However, Insurance Code section 790.03 contains an exception to this rule, as follows:

sex-based differentials in rates ... or benefits, or any combination thereof, shall not be required for ... any contract of life insurance ... issued pursuant to arrangements which may be considered terms, conditions, or privileges of employment as these terms are used in Title VII of the Civil Rights Act of 1964 (Public Law 88-352), as amended. Ins. Code § 790.03, subd. (f).

Hence, there can be no possibility of the proposed regulations even indirectly conflicting with this section of the Insurance Code to the extent that they approve the use of the Unisex Tables only for valuation of life insurance policies issued pursuant to employment arrangements that fall within the scope of this exception, since for these policies sex-based differentials are not required. The proposed regulations do not attempt to interpret the federal case law, statutes and regulations which determine the meaning of the Civil Rights Act of 1964, as amended. Rather, the regulations seek to embody the provisions of the Model Regulation to the greatest degree that is consistent with California law. For this reason, it is reasonably necessary that the proposed regulations permit the Unisex Tables to be used in valuing the broadest range of life policies as will fit within the exception, as articulated in California Insurance Code section 790.03, subdivision (f).

To this end, in order to limit the definition of “1980 CSO Valuation Tables” to include the Unisex Tables — and approve them for use under the proposed regulations — only to the extent that the Unisex Tables are used in the valuation of life policies that fit within the exception, it is necessary in the proposed regulations to reference and borrow directly from the language of the California statute to restrict the use of the Unisex Tables to “valuation under this article of life insurance contracts issued pursuant to arrangements which may be considered terms, conditions, or privileges of employment within the meaning of Subdivision (f) of Insurance Code Section 790.03.”

Section 2542.3, Subdivision (j)

In order to comply with Government Code sections 11340.5 and 11349.1, and with Title 1, California Code of Regulations, sections 16 and 20, it has been necessary to make the following additions to the corresponding language in the Model Regulation:

"Ten-year Select Factors" means the select factors (1981 *Transactions of the Society of Actuaries*, Volume 33, p. 669) adopted with the 1980 amendments to the NAIC Standard Valuation Law. The Ten-year Select Factors are hereby incorporated herein by reference.

State agencies are required to adopt as a regulation any “standard of general application, or other rule” they seek to enforce. Gov. Code § 11340.5. Since the table indicated in the Model Regulation’s definition of “Ten-Year Select Factors” could be construed to qualify as such a standard or rule, it must, arguably, be adopted as part of the proposed regulations, pursuant to the Administrative Procedure Act. In order to make this table part of the present regulations, it is necessary either to reprint it in the text of the proposed regulations or to incorporate it by reference into the proposed regulations.

Reprinting the Ten-Year Select Factors in the California Code of Regulations would be impractical, because it would unnecessarily introduce the possibility of error and because, owing to the fact that the table in question has been in use for over twenty years among insurers who are to be affected by the proposed regulations, reprinting the table in the California Code of Regulations would not be particularly useful. For this reason, it has been reasonably necessary to incorporate by reference the Ten-Year Select Factors, as defined in the Model Regulation, into the proposed regulations.

Title 1, California Code of Regulations, section 16 indicates that in the text of proposed regulations citation styles should be used that “clearly identify published material cited.” Cal. Code Regs., tit. 1, § 16. Title 1, California Code of Regulations, section 20 requires that for documents to be incorporated by reference the regulation text include an identification of such documents by “title and date of publication,” a specification of “which portions of the document[s] are being incorporated by reference,” and the inclusion of a statement to the effect that the documents are being incorporated by reference. Cal. Code Regs., tit. 1, § 20. For this

reason it has been reasonably necessary in the regulation text to include such a statement and to provide the required bibliographical information for the Ten-Year Select Factors.

The table indicated by the Model Regulation's definition of "Ten-Year Select Factors" is a component of the Commissioner's Standard Ordinary Mortality Table with Ten-Year Select Factors, which table is specifically identified in Insurance Code section 10489.2 as permissible for use as a basis of the minimum standard of valuation of life policies subject to the proposed regulations.

SECTION 2542.4. GENERAL CALCULATION REQUIREMENTS FOR BASIC RESERVES AND PREMIUM DEFICIENCY RESERVES

The purpose of this section is to set forth general calculation requirements for basic reserves and premium deficiency reserves. It contains a number of minor departures from the NAIC language, each as detailed below, which are arguably substantive in nature. Section 2542.4 is in all other respects substantially identical to the corresponding section of the Model Regulation; to the extent that the proposed regulations do duplicate the language of the Model Regulation, they are reasonably necessary in order to carry out the intent of the Legislature that the proposed regulations contain the provisions of the Model Regulation. The purpose and necessity of each arguably substantive deviation from the NAIC language are as set forth below.

Section 2542.4, Subdivision (a)

In order to avoid conflict with Insurance Code section 10489.2, it has been necessary to include in the text of the proposed regulations the following addition to the corresponding language in the Model Regulation: "At the election of the company for any one or more specified plans of life insurance, the minimum mortality standard for Basic Reserves may be calculated using the 1980 CSO Valuation Tables with or without select mortality factors (or any other valuation mortality table adopted by the NAIC after the effective date of this [article] and approved by regulation promulgated ~~by regulation~~ or bulletin issued by the commissioner for this purpose)."

Insurance Code Section 10489.2 identifies as one of the bases of the minimum standard for the valuation of policies to which the Standard Valuation Law is applicable the mortality tables identified in Subdivision (a) of that section. For the mortality tables to be used with all "ordinary" (as opposed to industrial) policies including those issued on or after the effective date of the proposed regulations, and to which the proposed regulations therefore apply, Subdivision (a) specifies three options, as follows:

(i) the Commissioners 1980 Standard Ordinary Mortality Table, or (ii) at the election of the company for any one or more specified plans of life insurance, the Commissioners 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors, or (iii) any ordinary mortality table, adopted after 1980 by the National Association of Insurance Commissioners, or its successor, that is approved by regulation promulgated

or bulletin issued by the commissioner for use in determining the minimum standard of valuation for such policies. Ins. Code § 10489.2, subd. (a).

The term “1980 CSO valuation tables” is defined in Section 2542.3 of the proposed regulations to mean the Commissioners’ 1980 Standard Ordinary Mortality Table *without select factors*. However, Insurance Code Section 10489.2 gives insurance companies the option to elect to use the Commissioners 1980 Standard Ordinary Mortality Table *with* Ten-Year Select Mortality Factors, as well. The language of the Model Regulation, however, by indicating that the minimum mortality standard may be calculated using the 1980 CSO valuation tables *with* select mortality factors, tends to suggest that the calculation cannot also be made using the 1980 CSO valuation tables *without* select factors. Alternatively, the NAIC language could be interpreted to mean that the 1980 CSO valuation tables without select factors are merely one available option among many other permissible, unspecified options. It is therefore reasonably necessary, in order to avoid restricting the choice of mortality tables available for use by insurers to a narrower range—or broadening the choice of available options to a wider range—than is provided by statute, that in the proposed regulations the phrase “or without” be inserted into the corresponding NAIC language. It is reasonably necessary that these words be inserted, in order to ensure that the proposed regulations maintain consistency with the statutory requirement that use of the 1980 Standard Ordinary Mortality Table *with* Ten-Year Select Mortality Factors be at the option of the company, but that if this option is not chosen, then either the Commissioners’ 1980 Standard Ordinary Mortality Table (without select factors) or another valuation mortality table, approved by the Commissioner, must be used.

In addition, because Insurance Code Section 10489.2 allocates to the commissioner the authority to approve “other” applicable mortality tables by bulletin, as well as by regulation, the proposed regulations would be at odds with the Insurance Code if they were to circumscribe the range of statutorily provided alternatives to only those tables approved by regulation. The above-identified language providing for approval by the Commissioner of mortality tables by bulletin, which in the proposed regulations has been inserted into the text of the Model Regulation therefore also represents an additional provision that is reasonably necessary in order to avoid creating an inconsistency with California statutory law.

Section 2542.4, Paragraph (a)(3)

In order to avoid conflict with Insurance Code section 10489.2, it has been necessary to include in the text of the proposed regulations the following addition to the corresponding language in the Model Regulation: “[If select mortality factors are elected, they may be:].... (3) Any other table of select mortality factors adopted by the NAIC after the effective date of this [article] and **approved by regulation** promulgated ~~by regulation~~ **or bulletin issued** by the commissioner for the purpose of calculating Basic Reserves.”

Insurance Code Section 10489.2 identifies as one of the bases of the minimum standard for the valuation of policies to which the Standard Valuation Law is applicable the mortality tables identified in Subdivision (a) of that section. For the mortality tables to be used with all

“ordinary” (as opposed to industrial) policies including those issued on or after the effective date of the proposed regulations, and to which the proposed regulations therefore apply, Subdivision (a) specifies three options, as follows:

(i) the Commissioners 1980 Standard Ordinary Mortality Table, or (ii) at the election of the company for any one or more specified plans of life insurance, the Commissioners 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors, or (iii) any ordinary mortality table, adopted after 1980 by the National Association of Insurance Commissioners, or its successor, that is approved by regulation promulgated or bulletin issued by the commissioner for use in determining the minimum standard of valuation for such policies. Ins. Code § 10489.2, subd. (a).

Because Insurance Code Section 10489.2 thus allocates to the Commissioner the authority to approve “other” applicable mortality tables by bulletin, as well as by regulation, the proposed regulations would be at odds with the Insurance Code if they were to circumscribe the range of statutorily provided alternatives to only those tables approved by regulation. The above-identified language which in the proposed regulations has been inserted into the text of the Model Regulation therefore represents an additional provision that is reasonably necessary in order to avoid creating an inconsistency with California statutory law.

Section 2542.4, Subdivision (b)

In order to avoid conflict with Insurance Code section 10489.2, it has been necessary to include in the text of the proposed regulations the following addition to the corresponding language in the Model Regulation: “Deficiency Reserves, if any, are calculated for each policy as the excess, if greater than zero, of the quantity A over the Basic Reserve. The quantity A is obtained by recalculating the Basic Reserve for the policy using Guaranteed Gross Premiums instead of net premiums when the Guaranteed Gross Premiums are less than the corresponding net premiums. At the election of the company for any one or more specified plans of insurance, the quantity A and the corresponding net premiums used in the determination of quantity A may be based upon the 1980 CSO Valuation Tables with **or without** select mortality factors (or any other valuation mortality table adopted by the NAIC after the effective date of this [article] and **approved by regulation** promulgated ~~by regulation or bulletin issued~~ by the commissioner).”

Insurance Code Section 10489.2 identifies as one of the bases of the minimum standard for the valuation of policies to which the Standard Valuation Law is applicable the mortality tables identified in Subdivision (a) of that section. For the mortality tables to be used with all “ordinary” (as opposed to industrial) policies including those issued on or after the effective date of the proposed regulations, and to which the proposed regulations therefore apply, Subdivision (a) specifies three options, as follows:

(i) the Commissioners 1980 Standard Ordinary Mortality Table, or (ii) at the election of the company for any one or more specified plans of life insurance, the Commissioners 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors, or

(iii) any ordinary mortality table, adopted after 1980 by the National Association of Insurance Commissioners, or its successor, that is approved by regulation promulgated or bulletin issued by the commissioner for use in determining the minimum standard of valuation for such policies. Ins. Code § 10489.2, subd. (a).

The term “1980 CSO valuation tables” is defined in Section 2542.3 of the proposed regulations to mean the Commissioners’ 1980 Standard Ordinary Mortality Table *without select factors*. However, Insurance Code Section 10489.2 gives insurance companies the option to elect to use the Commissioners 1980 Standard Ordinary Mortality Table *with* Ten-Year Select Mortality Factors, as well. The language of the Model Regulation, however, by indicating that Quantity A may be calculated using the 1980 CSO valuation tables *with* select mortality factors, tends to suggest that the calculation cannot also be made using the 1980 CSO valuation tables *without* select factors. Alternatively, the NAIC language could be interpreted to mean that the 1980 CSO valuation tables without select factors are merely one available option among many other permissible, unspecified options. It is therefore reasonably necessary, in order to avoid restricting the choice of mortality tables available for use by insurers to a narrower range—or broadening the choice of available options to a wider range—than is provided by statute, that in the proposed regulations the phrase “or without” be inserted into the corresponding NAIC language. It is reasonably necessary that these words be inserted, in order to ensure that the proposed regulations maintain consistency with the statutory requirement that use of the 1980 Standard Ordinary Mortality Table *with* Ten-Year Select Mortality Factors be at the option of the company, but that if this option is not chosen, then either the Commissioners’ 1980 Standard Ordinary Mortality Table (without select factors) or another valuation mortality table, approved by the Commissioner, must be used.

In addition, because Insurance Code Section 10489.2 allocates to the Commissioner the authority to approve “other” applicable mortality tables by bulletin, as well as by regulation, the proposed regulations would be at odds with the Insurance Code if they were to circumscribe the range of statutorily provided alternatives to only those tables approved by regulation. The above-identified language providing for approval by the Commissioner of mortality tables by bulletin, which in the proposed regulations has been inserted into the text of the Model Regulation therefore also represents an additional provision that is reasonably necessary in order to avoid creating an inconsistency with California statutory law.

Section 2542.4, Paragraph (b)(4)

In order to avoid conflict with Insurance Code section 10489.2, it has been necessary to include in the text of the proposed regulations the following addition to the corresponding language in the Model Regulation: “[If select mortality factors are elected, they may be:].... (4) Any other table of select mortality factors adopted by the NAIC after the effective date of this [article] and **approved by regulation** promulgated ~~by regulation~~ **or bulletin issued** by the commissioner for the purpose of calculating deficiency reserves.”

Insurance Code Section 10489.2 identifies as one of the bases of the minimum standard for the valuation of policies to which the Standard Valuation Law is applicable the mortality tables identified in Subdivision (a) of that section. For the mortality tables to be used with all “ordinary” (as opposed to industrial) policies including those issued on or after the effective date of the proposed regulations, and to which the proposed regulations therefore apply, Subdivision (a) specifies three options, as follows:

(i) the Commissioners 1980 Standard Ordinary Mortality Table, or (ii) at the election of the company for any one or more specified plans of life insurance, the Commissioners 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors, or (iii) any ordinary mortality table, adopted after 1980 by the National Association of Insurance Commissioners, or its successor, that is approved by regulation promulgated or bulletin issued by the commissioner for use in determining the minimum standard of valuation for such policies. Ins. Code § 10489.2, subd. (a).

Because Insurance Code Section 10489.2 thus allocates to the Commissioner the authority to approve “other” applicable mortality tables by bulletin, as well as by regulation, the proposed regulations would be at odds with the Insurance Code if they were to circumscribe the range of statutorily provided alternatives to only those tables approved by regulation. The above-identified language which in the proposed regulations has been inserted into the text of the Model Regulation therefore represents an additional provision that is reasonably necessary in order to avoid creating an inconsistency with California statutory law.

Section 2542.4, Subdivision (c)

In order to avoid potential ambiguity it has been necessary to insert into language of the Model Regulation the word “permissible” into the second sentence of this Subdivision, as follows: “This [Subdivision (c)] applies to both Basic Reserves and Deficiency Reserves. Any **permissible** set of select mortality factors may be used only for the first segment.” The Model Regulation’s use of the word “Any” is intended to signify that it is possible that no set of select mortality factors may be used but that if one is used, it can be used only for the first segment. Without the addition of the word “permissible,” however, it is conceivable that a strained reading of the NAIC language could yield the following meaning: For the first segment *any* set of mortality factors may be used, whether or not it is approved by statute, regulation or bulletin. This cannot be the intent of this provision, given the context of the Model Regulation where it is placed, in which careful attention is paid to setting out new select mortality factors and to identifying the alternative select mortality factors that can be used in certain circumstances. For purposes of clarity, it is therefore necessary to insert the word “permissible,” in order to eliminate the potential for this erroneous reading by making explicit the obvious intent of the NAIC language that if a set of mortality factors is used for the first segment, that set of mortality factors must be among those specified elsewhere in the proposed regulations as permissible.

SECTION 2542.5. CALCULATION OF MINIMUM VALUATION STANDARDS FOR POLICIES WITH GUARANTEED NONLEVEL GROSS PREMIUMS OR GUARANTEED NONLEVEL BENEFITS (OTHER THAN UNIVERSAL LIFE POLICIES)

The purpose of this section is to set forth calculation requirements for minimum valuation standards for policies (other than universal life policies) with guaranteed nonlevel gross premiums or guaranteed nonlevel benefits. It contains a number of minor departures from the NAIC language, each as detailed below, which are arguably substantive in nature. Section 2542.5 is in all other respects substantially identical to the corresponding section of the Model Regulation; to the extent that the proposed regulations do duplicate the language of the Model Regulation, they are reasonably necessary in order to carry out the intent of the Legislature that the proposed regulations contain the provisions of the Model Regulation. The purpose and necessity of each arguably substantive deviation from the NAIC language are as set forth below.

Section 2542.5, Paragraphs (e)(4) and (f)(4)

In order to avoid conflict with Insurance Code section 10489.2, it has been necessary to include in the text of the proposed regulations the following addition to the corresponding language in the Model Regulation: “For purposes of this [Subdivision (e)/(f)], the calculations use the Maximum Valuation Interest Rate and the 1980 CSO Valuation Tables with or without Ten-year Select Factors, or any other table adopted by the NAIC after the effective date of this [article] and **approved by regulation** promulgated ~~by regulation~~ **or bulletin issued** by the commissioner for this purpose.”

Insurance Code Section 10489.2 identifies as one of the bases of the minimum standard for the valuation of policies to which the Standard Valuation Law is applicable the mortality tables identified in Subdivision (a) of that section. For the mortality tables to be used with all “ordinary” (as opposed to industrial) policies including those issued on or after the effective date of the proposed regulations, and to which the proposed regulations therefore apply, Subdivision (a) specifies three options, as follows:

(i) the Commissioners 1980 Standard Ordinary Mortality Table, or (ii) at the election of the company for any one or more specified plans of life insurance, the Commissioners 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors, or (iii) any ordinary mortality table, adopted after 1980 by the National Association of Insurance Commissioners, or its successor, that is approved by regulation promulgated or bulletin issued by the commissioner for use in determining the minimum standard of valuation for such policies. Ins. Code § 10489.2, subd. (a).

Because Insurance Code Section 10489.2 thus allocates to the Commissioner the authority to approve “other” applicable mortality tables by bulletin, as well as by regulation, the proposed regulations would be at odds with the Insurance Code if they were to circumscribe the range of statutorily provided alternatives to only those tables approved by regulation. The above-identified language which in the proposed regulations has been inserted into the text of the

Model Regulation therefore represents an additional provision that is reasonably necessary in order to avoid creating an inconsistency with California statutory law.

Section 2542.5, Paragraph (f)(6)

In order to avoid potential ambiguity in the proposed regulations, it has been necessary to make the following change to the corresponding language of the Model Regulation:

- (6) For policies that become attained-age-based YRT policies after an initial period of coverage, the approach of this [Subdivision (f)] may be used after the initial period if:
- ~~(a) The initial period is constant for all insureds of the same sex, risk class and plan of insurance; or~~
 - ~~(b) The initial period runs to a common attained age for all insureds of the same sex, risk class and plan of insurance; and~~
 - ~~(c) (A) After the initial period of coverage, the policy meets the conditions of Paragraph (5) above; and~~
- (B) The conditions of either Item (i) or Item (ii) below are satisfied:**
- (i) The initial period runs to a common attained age for all insureds of the same sex, risk class and plan of insurance; or**
 - (ii) The initial period is constant for all insureds of the same sex, risk class and plan of insurance.**

Without the indicated change, the unmodified NAIC language could be interpreted to mean that either Subparagraph (a) alone or, otherwise, the combination of Subparagraphs (b) and (c) is sufficient to satisfy the requirements of Paragraph (6). In fact, the intended meaning of this NAIC language is that the requirement of Paragraph (6) can only be satisfied either by meeting the conditions of Subparagraphs (a) and (c) or by meeting the conditions of Subparagraphs (b) and (c). The reason why it is certain that the condition expressed in what in the unmodified NAIC language is Subparagraph (c), that “After the initial period of coverage, the policy meets the conditions of Paragraph (5) above,” must always be satisfied in order for Paragraph (6) to apply is explained below; for ease of reference, this condition, numbered Subparagraph (f)(6)(A) in the proposed regulations, together with the surrounding provisions, is referred to in the following explanation using the numbering system of the proposed regulations rather than the original numbering scheme employed in the Model Regulation.

Subparagraph (f)(6)(A) is part of Subdivision (f), which provides an optional alternative to the basic and deficiency reserve calculation methods otherwise required by Section 2542.5. This alternative is available only for policies which, pursuant to Paragraph (f)(5), qualify as “attained-age-based YRT policies.” Paragraph (f)(6), of which Subparagraph (f)(6)(A) is a component, in turn, specifies conditions which must be met in order for policies which initially are not, but subsequently become, attained-age-based YRT policies to be subject to the optional alternative reserve calculation method, at the time they become attained-age-based YRT policies. Because Subparagraph (f)(6)(A) contains only the requirement that such policies, after an initial period, must meet the conditions of Paragraph (f)(5), which sets out the conditions which must be

satisfied in order for any policy ever to be considered an attained-age-based YRT policy, Subparagraph (f)(6)(A) must, logically, always apply at the time such a policy can become subject to the optional alternative reserve calculation method for attained-age-based YRT policies, since it is only by virtue of satisfying Paragraph (f)(5) that any policy can qualify as an attained-age-based YRT policy in the first place and consequently be reserved for in accordance with the optional alternative method. For this reason, it is clear that the intention of the Model Regulation in this regard is to make the availability of the optional alternative reserve calculation method for policies that become attained-age-based YRT policies contingent in every case upon the policies' satisfying, after the initial period, the conditions of Paragraph (f)(5), which determine which policies can ever be considered attained-age-based YRT policies for this purpose. It is therefore necessary for purposes of clarity to insert into the proposed regulations at the beginning of Subparagraph (f)(6)(B) the indicated new language, and to reorder and renumber the corresponding subparagraphs of the Model Regulation accordingly.

SECTION 2542.6. CALCULATION OF MINIMUM VALUATION STANDARD FOR FLEXIBLE PREMIUM AND FIXED PREMIUM UNIVERSAL LIFE INSURANCE POLICIES THAT CONTAIN PROVISIONS RESULTING IN THE ABILITY OF A POLICYOWNER TO KEEP A POLICY IN FORCE OVER A SECONDARY GUARANTEE PERIOD

The purpose of this section is to set forth calculation requirements for minimum valuation standards for flexible premium and fixed premium universal life insurance policies that contain provisions resulting in the ability of a policyowner to keep a policy in force over a secondary guarantee period. It contains a number of additions to the NAIC language, each as detailed below, which are arguably substantive in nature. Section 2542.6 is in all other respects substantially identical to the corresponding section of the Model Regulation; to the extent that the proposed regulations do duplicate the language of the Model Regulation, they are reasonably necessary in order to carry out the intent of the Legislature that the proposed regulations contain the provisions of the Model Regulation. The purpose and necessity of each arguably substantive departure from the NAIC language are as set forth below.

Section 2542.6, Subparagraph (a)(1)(B)

In order to avoid conflict with Insurance Code section 10489.2, it has been necessary to include in the text of the proposed regulations the following addition to the corresponding language in the Model Regulation: “[Policies with a secondary guarantee include:] A policy in which the minimum premium at any duration is less than the corresponding one year valuation premium, calculated using the Maximum Valuation Interest Rate and the 1980 CSO Valuation Tables with or without Ten-year Select Factors, or any other table adopted after the effective date of this [article] by the NAIC and **approved by regulation** promulgated ~~by regulation or bulletin~~ **issued** by the commissioner for this purpose”

Insurance Code Section 10489.2 identifies as one of the bases of the minimum standard for the valuation of policies to which the Standard Valuation Law is applicable the mortality tables identified in Subdivision (a) of that section. For the mortality tables to be used with all

“ordinary” (as opposed to industrial) policies including those issued on or after the effective date of the proposed regulations, and to which the proposed regulations therefore apply, Subdivision (a) specifies three options, as follows:

(i) the Commissioners 1980 Standard Ordinary Mortality Table, or (ii) at the election of the company for any one or more specified plans of life insurance, the Commissioners 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors, or (iii) any ordinary mortality table, adopted after 1980 by the National Association of Insurance Commissioners, or its successor, that is approved by regulation promulgated or bulletin issued by the commissioner for use in determining the minimum standard of valuation for such policies. Ins. Code § 10489.2, subd. (a).

Because Insurance Code Section 10489.2 thus allocates to the Commissioner the authority to approve “other” applicable mortality tables by bulletin, as well as by regulation, the proposed regulations would be at odds with the Insurance Code if they were to circumscribe the range of statutorily provided alternatives to only those tables approved by regulation. The above-identified language which in the proposed regulations has been inserted into the text of the Model Regulation therefore represents an additional provision that is reasonably necessary in order to avoid creating an inconsistency with California statutory law.

Section 2542.6, Paragraph (a)(3)

The following language has been added: “Specified premiums may be stated directly or implied. For example, specified premiums may be implied via a guarantee that the policy will not lapse if the accumulation of premiums less withdrawals as of any given date exceeds a certain dollar amount. Such accumulation may or may not reflect interest and/or deductions for cost of insurance or expense.”

The direct statement of specified premiums is defined in the current language in the Model Regulation, which is included in the proposed regulations without change. The language indicating that specified premiums may be implied as well as stated directly is necessary in order to ensure that the applicability of this section cannot be avoided by policies which otherwise might elude classification as a policy with a secondary guarantee and consequently escape the special reserving requirements therefor provided in this section. An example of how specified premiums could be implied only which is not specifically illustrated in the added language is a policy incorporating a cumulative premium catch-up provision. Under this policy design, coverage is guaranteed as long as a stipulated premium is paid each year, but in the event the insured is paying less than the stipulated premium, there remains a very broad right under the policy to make up such deficiencies in the future and thereby keep coverage in force. The added language recognizing the possibility that specified premiums may be implied is necessary in order to account for this and similar policy designs.

Another way specified premiums may be implied is illustrated in the example given in the new language itself, where the specified premiums are implied via a secondary guarantee that the

policy will not lapse, provided the accumulation of premiums exceeds a certain dollar amount. Typically the accumulation of premiums that is required by these non-lapse guarantees is such that the accumulated premiums would otherwise be insufficient to keep the policy in force, particularly taking into consideration deductions which would ordinarily be made in a universal life policy for cost of insurance and/or expense. The accumulation of premiums for the secondary guarantee may be specified in a policy without specific reference to interest and/or deductions for the cost of insurance and/or expense. Alternatively, a higher guaranteed interest rate and a lower cost of insurance and/or other expense may be used in the calculation of the accumulation of premiums than are otherwise credited or charged, respectively, to the policy. The last sentence in this Paragraph (a)(3) has been added in order to ensure that all these eventualities are taken into account in the determination of specified premiums.

Section 2542.6, Subdivision (b)

The following sentence has been added: “Any contract provision guaranteeing that the death benefit will be kept in force even when the policy account or cash value is zero must be valued consistently with the principles underlying this article.”

This additional language is necessary in order to take into account unforeseen policy designs that may appear in the future and that might, for purely technical reasons, not otherwise be subject to the provisions of this section. Policy designs that tend to skirt the applicability of the Model Regulation are constantly emerging. For this reason, the NAIC is already working on Actuarial Guideline “AXXX,” which is intended to clarify how the Model Regulation should be interpreted for some of these problematic new policy designs. The additional language in this section will provide the necessary basis for ensuring that the applicable valuation requirements apply to universal life policies with secondary guarantees, notwithstanding the emergence of new policies that are designed to defy categorization as such under the proposed regulations but which nonetheless possess this essential characteristic of such policies: The death benefit may remain in force even though the cash value or account value has reached zero.

An example of a possible design which, but for the added language, could conceivably elude the applicability of this section, is as follows. A Universal life policy guarantees that if it lapses prior to the 10th policy anniversary but stipulated premiums have been paid, a substitute policy will be issued providing the same amount of insurance coverage at the same stipulated premium for the remainder of the 10-year period plus an additional 20 years. Without the above-mentioned additional language, an insurer could conceivably base the reserves for such a policy only on the initial 10-year guarantee. Because of the new language, a higher reserve, based on a 30-year guarantee, would be required, as necessary in order to serve the overarching purpose of the proposed regulations that reserves must be established that are commensurate with the guarantees actually made in a policy.

Section 2542.6, Subdivision (d)

This subdivision, entitled “Recognition of Actual Premiums Paid,” had been added. It consists of the following sentence: “If the accumulation of actual premiums paid up through the valuation date is a factor in determining the amount of future premiums necessary to satisfy the secondary guarantee requirement, then the basic and deficiency reserves must be adjusted to reflect this factor.”

The inclusion of this language in the proposed regulations is necessary in order to ensure that appropriate reserves are established for certain universal life policies with secondary guarantees, for example, policies designed with a shadow account guarantee that considers actual premiums paid to the valuation date in calculating the accumulation of premiums. A universal life policy with a shadow account works as follows: The basic policy account value is equal to premiums paid plus interest credited less mortality and expense charges. The cash surrender value is equal to the account value less a surrender charge. Ordinarily, if the account or cash value goes down to zero, the policy will expire. A shadow account is another fund that is calculated in a similar fashion. However, when the balance of the shadow account is calculated, the guaranteed interest credits are typically higher and the mortality and expense charges are typically lower than those used to determine the basic account value. The policy guarantees that coverage under the policy will not expire as long as the shadow account value is positive, even if the basic policy account value is zero or negative.

The basic and deficiency reserve calculations for the secondary guarantee, effected in the above example by means of a shadow account, should account for the actual premiums paid to date to the extent these paid-in premiums reduce the premiums that must be paid in the future in order to maintain the secondary guarantee in force. The above-mentioned additional language is reasonably necessary in order to require that valuation under the proposed regulations is not skewed by an assumption, which might otherwise be used, that more premiums will be received in the future than the amount that is actually sufficient to satisfy the secondary guarantee requirement.

SECTION 2542.8. SELECT MORTALITY FACTORS

This section specifies select mortality factors which for use in valuating life insurance policies to which these regulations pertain. It is substantially identical to the corresponding section of the Model Regulation; it is therefore reasonably necessary in order to carry out the intent of the Legislature that the proposed regulations contain the provisions of the Model Regulation.

IDENTIFICATION OF STUDIES

There are no specific studies relied upon in the adoption of this article.

SPECIFIC TECHNOLOGIES OR EQUIPMENT

Adoption of these regulations would not mandate the use of specific technologies or equipment.

ALTERNATIVES

The Commissioner has determined that no reasonable alternative exists to carry out the purpose for which the regulations are proposed. Performance standards were considered but were rejected as an unreasonable and impracticable alternative in the context of regulations that seek efficiently to define specific rules for the valuation of life insurance policies.

ECONOMIC IMPACT ON SMALL BUSINESS

The Commissioner has identified no reasonable alternatives to the presently proposed regulations, nor have any such alternatives otherwise been identified and brought to the attention of the Department, that would lessen any impact on small business. Although performance standards were considered as an alternative, they were rejected, in part, because the kind of risks from which the regulations seek to protect consumers cannot practicably be gauged by means of a performance standard.

PRENOTICE DISCUSSIONS

The Commissioner has not conducted prenotice public discussions pursuant to Government Code Section 11346.45, because the affected parties who would have been invited to participate in such discussions — primarily insurers — have in fact been operating in accordance with the substantive provisions of the proposed regulations since July 1, 2000, when they were made effective by the issuance of Department of Insurance Bulletin 2000-2, as discussed above. For this reason, it is unlikely that the interested parties will find the proposed regulations too complex or multifarious to be reviewed easily during the comment period. Additionally, because the proposed regulations are, in large part, substantially identical to the Model Regulation, whose provisions the Statute explicitly indicates it is the Legislature's intent that the Commissioner adopt, it is not anticipated that the adoption of the proposed regulations will be particularly controversial.